DOW THEORY LETTERS INC.

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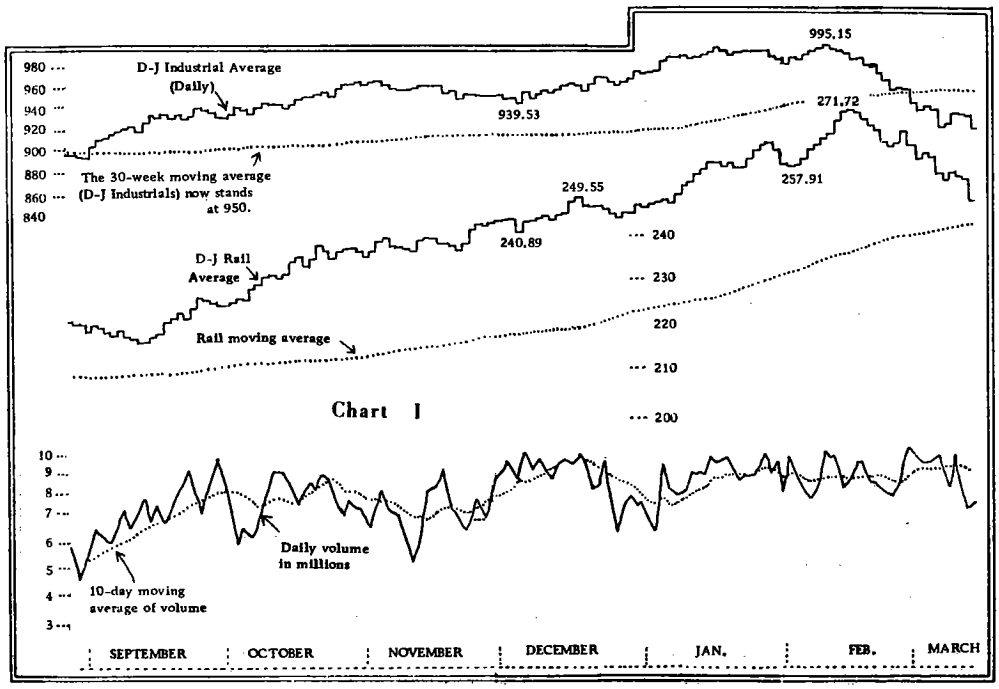
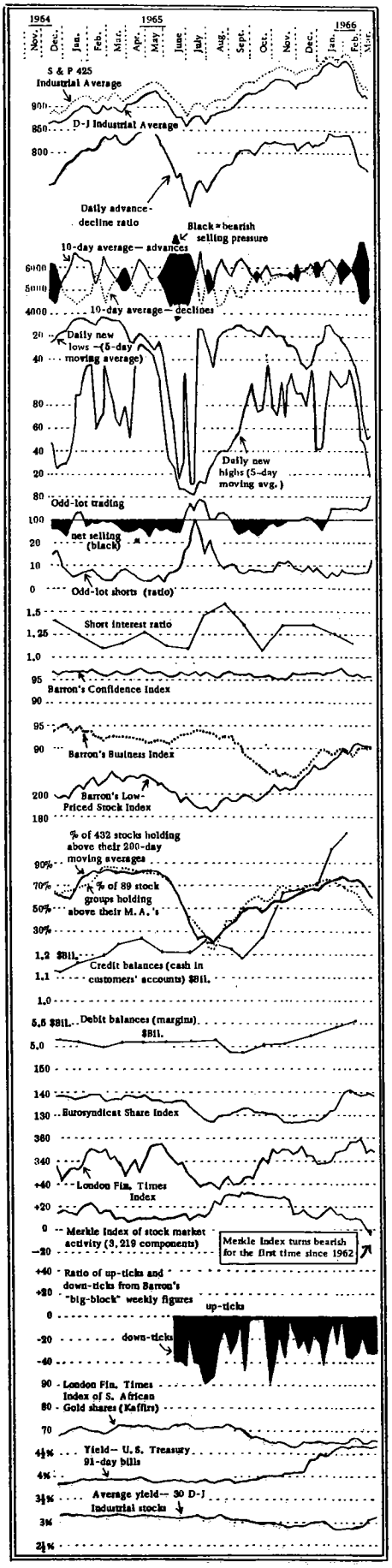
THE MARKET: What happened to 1000 on the Dow? Was it all a dream? Or to put it more brutally, was it a trap of the type which periodically has cost Wall Street and the public so dearly? In a month, from the 995.15 peak of February 9, the Industrial Average tumbled 77 points. The rally was unimpressive, and as this Letter is written the market is weakening again. Unfortunately, there isn't a man alive who can say with certainty whether a bear market has started. There are only guesses and opinions. On June 2, 1934, the great Dow Theorist Robert Rhea wrote: "...I have frequently implied that neither I nor any man can possibly know, with certainty, the primary direction of the market when the Averages are backing and filling in an area between a primary high point and a secondary low." The lows have yet to be established, but I will state that I do not like the action so far. I do not like the dullness which accompanied the rally from the March 7 low. I do not like the way the market is dropping during the early part of this week. I do not like the "tone and feel" of the steady liquidation which brings in increasing volume as soon as this market starts down. And I do not care for the insistent character of the selling.

One thing seems clear to me, and that is that the public is heavily in this market and that the public remained heavily in the market all the way through the February-March decline. Elements of "froth" and speculation persisted during the whole drop, and the only conclusion I can draw is that a bargain-hunting public accepted the decline as a heaven-sent opportunity to pick up more stock. This is in sharp contrast with the May-June, 1965 decline. For instance, during the worst 8 days of the decline between May 24 and June 28, 1965 (when the Dow lost 112 points), odd-lotters sold 450,000 shares on balance. But during the week ending March 4, 1965 (at which time the Dow lost 20 points on the biggest volume, 50,000,000 in market history), odd-lotters purchased a whopping 840,000 shares on balance. This type of public enthusiasm is dangerous, and merely fortifies my doubts about the wisdom of holding shares at this time. Large interests seem to be transferring their shares to the public as fast as the latter will take the stock off their hands. So much for the near-term situation, but what about the big picture?

I have studied most of the bull and bear markets of the past with great care. In general, I would say that two observations seem applicable to all bear markets: (1) Bear markets




1964
1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average — advances
10-day average — declines
Daily new lows (5-day moving average)
Daily new highs (5-day moving avg.)
Odd-lot trading
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Merkle Index turns bearish for the first time since 1962
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield — U.S. Treasury 91-day bills
Average yield — 30 D-J Industrial stocks

always seem to come "at the wrong time," or at the most embarrassing time for the nation and the economy. In other words, bear markets have the nasty habit of appearing when they are least appreciated. (2) Bear markets always arrive when such occurrences seems well-nigh "impossible." This is another way of saying that bear markets, when they arrive, tend to make fools of the public, the analysts and the majority of professional investment men.

With the above in mind, what were some of the psychological considerations which accompanied the February-March decline? First, I note that the majority of the many investment services which I read are already proclaiming that this is a secondary reaction, and that the worst has probably been seen. For instance, one well known analyst wrote last week: "I would qualify what is currently happening as one more of the bull market shakeouts which generally have a way of taking place before a full fledge major and climactic bull market top." Another service goes further: "If. . . .signals received during the past two months, the high monthly short interest, our graphs of new highs and lows and the tremendous size of the uncommitted millions in the hands of the mutual funds convince you, as they do us, that much of the bull market still lies ahead, then. . . .buy."

A second consideration is that the decline which started last February, came with no news to account for the drop. If subscribers remember, the 1957 decline was set off by the Russian "Sputnik" panic and the widespread fear that the Communists had pulled ahead of us in the space race. The sudden realization (Americans had been led to believe that the Russians were "backward") that the Russians were actually ahead of us in many aspects of space seemed to unleash a torrent of unreasoning fear. In 1962 the decline was touched off by the shock of the confrontation between President Kennedy and U.S. Steel. Again a specific news event served to strike terror into the heart of investors across the nation. In response to this event, the market went into a 100 point tailspin. But the most recent decline has occured "out of a clear blue sky." There was no news and no specific event to send the market hurdling down. This is the usual way that bear markets (as opposed to secondary reactions) start. At any rate, it is a phenomenon which should be carefully considered at this time.

Finally, a disturbing factor about which I have written before is that whatever technical deterioration has appeared on the decline so far has appeared after the market turned down. This was the case during May-June, 1965, but it was almost more pronounced during February and March (note the increase in odd-lot buying as the market headed down.)

"Look Russell," a subscriber asked last week, "this market has dropped 77 points in a month. What do you really think is going on, and what should I do about it?" Here is my opinion, and my answer at this point must be an opinion. I feel that the problem should be handled as a problem in investor strategy. In the absence of an orthodox bear signal, I

NOTES AND QUOTES: The Federal Reserve last week released a report which told how an international currency operation staved off the "speculators" against the pound (during late 1965). The Fed noted that central bankers propped up sterling thereby driving short sellers (against the pound) to the wall. What the report did not state is that the short sellers are now about out of the market. Thus the big technical prop (i.e. the shorts) under the pound has been removed. Last week the fundamentals again reaserted themselves, and the pound dropped to its lowest level in six months. This writer suspects that another crisis in sterling is in the making. The British balance-of-payments turned unexpectedly bad in January, and latest statistics show continued erosion of the British competitive position. Wages in Britain are now 5.1% above a year ago, retail prices 4.4% above a year ago, export prices 3% above a year ago. The situation is so bad that the Prime Minister was recently prompted to excoriate Britons for their "sheer damn laziness" and to call for a "full day's work for a full day's pay." If the pound goes down this time, it is doubtful whether the U.S. will (or will be able to) bail Britain out again.

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The French position on the new liquidity plans under survey by the International Monetary Fund remains unchanged. DeGaulle's chief advisor on monetary matters is his foreign minister, Couve de Murville, an old disciple of Jacques Rueff. Rueff is an anti-inflationist and is an advocate of the full gold standard. The March 5 issue of the Economist listed five of deGaulle's precepts on liquidity, three of which follow. (1) "There is only one valid foundation for the international monetary system; gold and again gold." (2) "DeGaulle seems to scorn all schemes for the creation of liquidity alike. Even the collective reserve unit, the CRU, which d'Estaing put forward as an official French plan, does not escape his contempt." (3) "DeGaulle has not stated his own alternative openly, but it is evident from all his other remarks; there is only one genuine way of envisaging the creation of additional liquidity if the world needs it one day—an increase in the price of gold."

Pound Sterling's Value Slips

LONDON (Reuters) — The pound sterling was under pressure again yesterday and slid another fraction below its par value of $2.80.

For the second day the Bank of England stepped into the market to bolster the currency.

The pound, which has been showing weakness for several weeks, dipped to $2.7947 by the close of trading — 0.18 cents lower than Monday, despite some official support.

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At the same time that he was asking Congress for a supplemental $4.8 billion for the war in Vietnam, President Johnson presented plans for a new health and education program, a new modernization plan for hospitals, a salary raise for government workers, a college development program, a new Federal Department of Transportation, a plan to end pollution in rivers, a bill for a battle against ignorance, disease and poverty "throughout the world," and so forth. The president made so many recommendations to the first session of the 89th Congress that to list them in brief required 12 pages of fine print in the Congressional Quarterly. Along with the new plans went a request for tax changes which, along with the new Social Security rise, will take more than 8 billion dollars in additional taxes from individuals and corporations in 1966.

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Eleven leading economists were interviewed by U.S. News and World Report (March 14) in an article entitled "How Much Inflation Ahead?" "A growing concern over inflationary pressures is shared by most of these economists," states the article. "Many now urge strong and quick action by Government to contain these pressures and prolong prosperity." My comment: I have expressed my scepticism regarding inflation over the foreseeable future. I believe that deflation is going to be the problem for investors for the next couple of years. The recent action of the stock and bond markets would tend to support my thesis, rather than the almost universal belief in "more inflation."

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Vietnam aside: As an old World War II bombardier, this writer was weaned on killing the enemy economically, with old fashioned 500 and 1000 pounders. I am therefore continually amazed by the costs of the Vietnam war. According to Newsweek (March 14) "Ammunition alone is costing the U.S. $220 million a month." In 1965 the U.S. forces used 1 billion rounds of small arms ammunition, which would seem to be a lot of trigger pulling for each enemy killed. At any rate, Newsweek figures it costs $375,000 to kill each VC. Would it be cheaper to pension them off?

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John Kenneth Galbraith was out here in San Diego last week, and I listened to him give a speech on U.S. foreign policy. Mr. Galbraith, author of "The Affluent Society," is also considered to be one of the intellectual leaders of Keynesian economics. I waited patiently for Mr. G to say something about our economy or even the world economic situation. I heard not a word on the subject. After the lecture I was tempted to ask Galbraith what he thought of the current state of Keynesian economics, but on second thought I decided not to. Perhaps it was no accident that one of our leading Keynesians had chosen to speak on a subject other than his specialty.

suggest that my subscribers continue to act "as if" we are in either the early stages of a major bear market or a broad trading range during which the market is forming a massive top. To put it bluntly, this is a very, very old bull market (if it is still a bull market), money is tightening rapidly, the U.S. is fighting a costly war from which it cannot extricate itself, the dollar is inflated, our gold stock is depleted, the British pound (the other reserve currency) is wobbly, and in the face of this, stocks are high and speculation is rampant. I believe at this point that discretion is the better part of valor. What is to be lost by acting as if a bear market has started? The answer is nothing. Therefore, I continue to recommend the following sheltered position for subscribers: 10% to 20% of assets in assorted gold shares and the rest in 91-day U.S. Treasury bills.

Conclusion: The rapidity and violence of the drop has been extraordinary. Starting from the February, 1966 top, the loss in Industrial points for the first three weeks of the decline has been 46% greater than the comparable loss (during the first three weeks) from the May 14, 1965 top. So far, selling pressure has been impressive, but interestingly buying power never really caved in as might be expected near the termination of an important decline. One test of this thesis is that although daily declines (a gauge of selling pressure) have been heavy on successive decline days, daily advances (a gauge of buying power) never dropped below 200 on any single downside day. In other words, the selling has (so far) been selective. Generally, declines such as the type we have been witnessing end amidst panic or semi-panic conditions. When this occurs, selling becomes non-selective and "everything that isn't nailed down" declines. This type of panic selling would probably produce 900 to 1000 or more declines on a given day and less than 200 advances together with heavy volume and greatly expanded odd-lot shorting. From a Dow Theory standpoint, the secondary trend is now bearish, and the primary trend (allowing for any doubts which we may harbor) is still considered up. The bullish primary designation will be in effect until such time as an orthodox bear signal may be rendered. This in no way implies that one should remain optimistic about stocks, a point discussed at the bottom of page 2 in the last Letter.

PRESSURE: The response to Letter 314's discussion of individual investor psychology (the section entitled "You") was unexpectedly large. Because there seems to be so much interest in the problem of investor psychology, I am following that discussion with one of tactics.

Here is one of the sorriest stories in investing. Two individuals are bullish on the market. Both have decided that Westinghouse is an excellent choice for the next advance. Investor A is a millionaire. He decides that Westinghouse is a good value and that he will purchase 1000 shares as a start. Although he has no exact plan in mind, he will probably double and then triple his commitment in Westinghouse if the stock starts to rise satisfactorily.

Investor B has a total capital of $50,000, mostly the savings from his own business. He buys 500 shares of Westinghouse, an amount which ties up the majority of his capital. Investor B thinks this way: "If my calculations and instincts are correct, Westinghouse could double. If it does, I'll have better than doubled my total capital. Come on Westinghouse, if you ever rallied, rally now!"

A few weeks later the general market goes into a reaction. Westinghouse declines with the market, even though its relative strength performance shows that it is not declining as fast as the market (in other words, its R.S. line is actually improving). But when Westinghouse declines 12% investor B starts losing sleep. At the bottom of the reaction Westinghouse is off 16%, and investor B, now in a thorough state of shock, sells out his position and sustains a large loss. Meanwhile, our millionaire, investor A, has decided (1) that this is probably a secondary reaction, not a bear market, (2) that even if it turns out to be a bear market he will be better off (in view of Westinghouse's excellent relative strength performance) selling Westinghouse during the next rally.

Actually, it did not matter whether it was a bear market and investor A sustained perhaps a slight loss or broke even, or whether it was a secondary reaction and investor A ended up with a tidy profit. What did matter was that investor A had the odds with him while investor B did not.

The reason why investor A broke even or made money while investor B lost money was not that A "was rich to start with" while B was not. The reason was that investor B put himself in a position (with his very large relative investment) whereby any decline would push him to the psychological brink. Conversely, investor A, with a relatively small part of his total capital invested in Westinghouse, was immune to psychological pressure. He was able to act free of emotions, regardless of what the market did.

This is a critical factor in investing and something I hope all my subscribers will remember. It boils down to this: "The market can do anything," and any time you are overly invested in a stock you are at the mercy of the marketplace, which means the unexpected. When you assume a position which is so large that it "forces you to the wall" on the first setback, you are in a very vulnerable position, both financially and psychologically. I always turn to this thought when I purchase a stock: "The odds are that I may sustain a small paper loss in this stock before I show a paper profit. If my initial position is too large, will I be able to sit with a paper loss or will I panic?" If, in my own mind, a 5% to 10% paper loss will cause me to panic out, then I am buying too much to start with.

MONEY TALKS: On March 10 many leading banks, led by Morgan Guarantee, raised the prime rate (the rate charged to their premium customers) from 5% to 5½%. This is the highest prime rate since the establishment of that rate in the mid-1930's. The new rates will spread out into every sector of the economy, but they will particularly affect finance companies and factors (who borrow from the banks) and who finance a good deal of the consumer purchases (autos, appliances, etc.). The result will be increasing problems in financing all manner and types of retail goods.

Magic 5 Per Cent Spreads in City

The move to pay the "magic" 5 per cent on individual savings certificates of nine month's maturity or more spread to three more New York City banks yesterday — the Manufacturers Hanover Trust Company, the Chemical Bank New York Trust and the Bank of New York.

At Manufacturers, a $10,000 minimum investment is required; at the Bank of New York, as at most other large banks in the city, the minimum is $2,500. Chemical has no specified minimum.

Meanwhile, the Franklin National Bank, which is leading the pack among New York-area banks with a rate of 5-1 per cent, announced some further details of its savings plan.

The rise in the prime rate should have come as no surprise to readers of these Letters, and I have been indicating that such a rise had to come. The reason it had to come was simple (see accompanying clip); the banks have been paying up to 5¼% for Certificates of Deposit. If the banks have to pay 5% and over for new money, it is obvious that they will want to lend that money out at much higher rates than the old prime rate of 5%. The significant things about the rate rise, however, is that the prime rate was increased before another Federal Reserve Board boost in the discount rate. Normally, the discount rate is raised, and then the prime rate follows. Translation: the Fed has lost control of the money market. The reluctant Fed is now in the position of following the money market instead of setting the pace. This loss of control by the Administration must be construed bearishly. It is now clear that in the choice of persuing the war in Vietnam or holding up the stock market, Washington has chosen (as if it had any other choice) the war in Vietnam.

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This month is a crucial one for the money market. Before March is over, $4.1 billion in Certificates of Deposit will run out at 250 banks across the nation. This is the largest number of C/D's to mature in a single month since these instruments were introduced in February, 1961. Much of this money will be needed by corporations for taxes, and anticipating the squeeze, a few leading N.Y. banks have begun offering 5¼% for C/D's maturing in nine months or less. Already, banks have backed away from financing speculative and "non-essential" ventures and financing for such loans as convertible bond leverage loans are now about out. A warning to convertible holders, expect your convertibles to sell at an increasingly narrow premium over actual conversion price.

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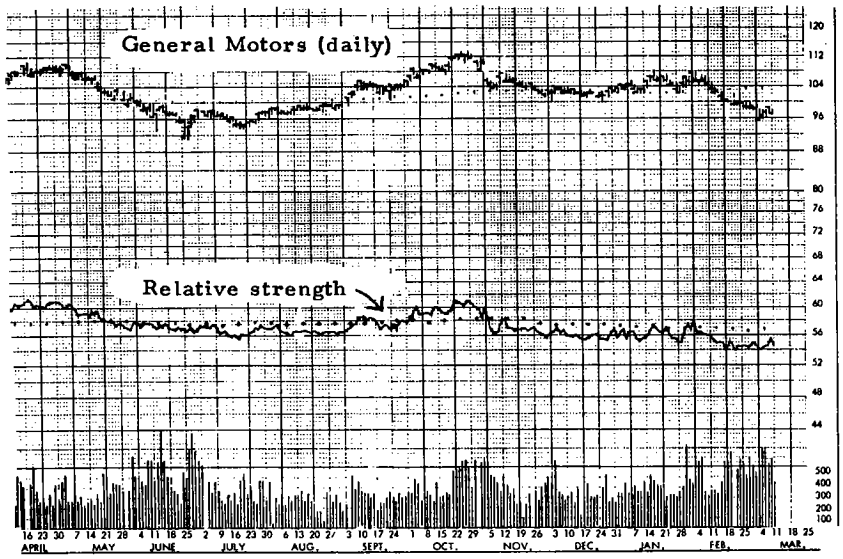
To those subscribers who do not believe that a potential monetary crisis is important, I urge them to think about this. The headline on Ward's Automotive Reports (which arrived here today) is reproduced here. This would be a rather uncomfortable situation if tight money started squeezing auto sales. And that, by the way, is exactly what I believe could be in the offing.

Record 1,497,400 New Car Inventory Portends Lively Sales Battle!

The Composite Chart on page 1 is practically self explanatory this week. The odd-lot profile is particularly interesting as is percentage of groups holding above their 30-week moving average (this has now turned bearish at 44%). The Merkle Index has issued its bearish warning by dropping below zero for the first time since 1962. Big block transactions have remained heavily on the downside since mid-January. In all, the indicators do not present a happy appearance.



STOCKS: The following groups are, so far, proving outstanding in relative strength: glass, containers, motion pictures, farm equipment. The longer the decline carries, the better the chance we will have to gauge the superior relative strength performances.

Once again I am going to draw attention to giant General Motors. The accompanying chart shows GM's relative strength breaking to the lowest point in a year. The stock has already turned bearish but 90 would break its 1965 low. For those who wish to speculate on the short side, I would suggest a short GM with a nearby stop at 100. Or another way of "playing" this stock would be a six-month put option, preferably obtained at a discount (I would consider a put on GM at 85 for around $500 to be an interesting speculation). Following is a list of other short candidates for speculators with "stop-buy" points in parentheses. All of these issues are in established relative strength downtrends: Beneficial Finance (53), Celanese (78), Dr. Pepper (34), Dow Chemical (74), Gulf Oil (56), R.H. Macy (49), J.C. Penny (62), Sears (62), Texaco (76), Transamerica (39), Union Carbide (67). Note the ominous number of consumer-oriented and "backbone of the economy" type stocks.

Chart of GM courtesy of Traders Research, 1431 Pearl St, Alton, Ill. 62003.